

REPORT OF
FINANCIAL EXAMINATION

NATIONAL STATES INSURANCE COMPANY

AS OF
DECEMBER 31, 2004



STATE OF MISSOURI
DEPARTMENT OF INSURANCE
JEFFERSON CITY, MISSOURI

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December 9, 2005
St. Louis, Missouri

Honorable Kevin McCarty, Commissioner
Florida Office of Insurance Regulation
Chair of the NAIC Financial Condition (E) Committee

Honorable Jorge Gomez, Commissioner
Wisconsin Office of the Commissioner of Insurance
Secretary of the Midwestern Zone, NAIC

Honorable W. Dale Finke, Director
Missouri Department of Insurance
301 West High Street, Room 630
Jefferson City, MO 65101

Gentlemen:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

National States Insurance Company

also referred to as "National States" or as the "Company." The examination was conducted at the Company's home office at 1830 Craig Park Court, St. Louis, Missouri 63146, telephone number (314) 878-0101. This examination began on March 14, 2005, and concluded December 9, 2005.

SCOPE OF EXAMINATION

Period Covered

The prior full scope association financial examination of National States Insurance Company was performed as of December 31, 2001. The examination was conducted by examiners from the state of Missouri representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC) with no other zones participating.

The current full scope association financial examination covers the period from January 1, 2002, through December 31, 2004. The examination was conducted by examiners from the state of Missouri representing the Midwestern Zone of the NAIC with no other zones participating. The firm of Milliman USA reviewed reserves and related actuarial items pursuant to a contract with the Missouri Department of Insurance.

This examination also included material transactions and/or events occurring after December 31, 2004.

Procedures

This examination was conducted using the guidelines set forth in the Financial Condition Examiners Handbook of the NAIC, except where practices, procedures and applicable regulations of the Missouri Department of Insurance and statutes of the state of Missouri prevailed.

Comments Previous Examination

The general comments and recommendations in the previous examination report and the Company's response and/or subsequent action taken by the Company are listed below.

1. Comment: The Company's minutes did not reflect the board's review of the 1998 Missouri Department of Insurance Report of Financial Examination. It is recommended that the Company properly document the review of significant corporate transactions and events in the minutes of board of directors meetings.

Company's Response: "The Company agrees with the finding and will properly document future examination reports in the minutes of the board of directors meetings."

Current Findings:

The Board reviewed, discussed and approved the prior examination (12/31/01) on December 10, 2002.

2. Comment: It is recommended that the Company develop a disaster recovery/business continuity plan. The plan should be updated and tested periodically, including the restoration of financially significant systems from backup media.

Company's Response: "The Company provided a copy of its business recovery plan.

Current Findings:

Although the Company did have a written business recovery plan, the plan indicates that "successful recovery operations depend on" several conditions. Two of

those conditions were “Performing tests of the Business Recovery Plan” and “Modifying the Business Recovery Plan based on test results.” The Company has not tested its plan.

The Company should regularly test its business continuity/disaster recovery plan and modify it as necessary based on the test results. Without a current plan, improved via periodic walk-through/restoration testing, the contingency planning process has diminished value because a variety of unforeseen problems may arise that have not been “refined out” of the recovery process.

HISTORY

General

The Company was incorporated under the laws of Missouri on July 22, 1964, and was licensed and commenced business on September 14, 1964. The Company was incorporated and licensed under Chapter 376 RSMo, (Life, Health and Accident Insurance) as a joint stock life insurance company.

The Company’s name was originally American Independence Life Insurance Company. In 1967 the Company reorganized and changed its name to National States Insurance Company and the present ownership assumed control.

Capital Stock

The Company is authorized to issue six million (6,000,000) shares of common stock with a par value of \$2.00 per share. As of December 31, 2004, three million five hundred thousand (3,500,000) shares were issued and outstanding at \$2.19 per share resulting in Capital Stock of \$7,000,000 (\$2.00 per share) and Gross Paid In and Contributed Surplus of \$667,619 (\$.19 per share).

Dividends

The Company has declared and paid dividends to stockholders as follows:

	<u>Cash</u>	<u>Stock</u>
Through December 31, 1994	\$ 810,000	\$ 6,713,330
1995-2004	-	-
Total	<u>\$ 810,000</u>	<u>\$ 6,713,330</u>

Management

The board of directors consists of nine members duly elected at an annual meeting of the stockholders as authorized by the Company's articles of incorporation. The directors duly elected and serving as of December 31, 2004, were as follows:

<u>Name</u>	<u>Principal Occupation</u>
Robert A. Bonney St. Charles, Missouri	Partner Blackstone Group
Thomas R. Green St. Louis, Missouri	President National States Insurance Company
Melvin Gross St. Petersburg, Florida	Owner Fidelity Assurance, Inc.
Martin E. Harrington St. Louis, Missouri	Chairman of the Board Royal Banks of Missouri
Rex M. Durington St. Louis, Missouri	Chief Actuary National States Insurance Company

<u>Name</u>	<u>Principal Occupation</u>
William R. Morrison St. Peters, Missouri	Vice President National States Insurance Company
Patricia I. Curran St. Louis, Missouri	Secretary and Treasurer National States Insurance Company
Matthias D. Renner St. Louis, Missouri	President National Real Estate Management Corp.
Dale D. Turvey St. Louis, Missouri	President Dale Turvey and Associates

The officers elected and serving as of December 31, 2004, were as follows:

<u>Name</u>	<u>Office</u>
Thomas R. Green	President
Patricia I. Curran	Secretary and Treasurer
William R. Morrison	Vice President
Rodney R. Brown	Vice President
Rex M. Durlington	Chief Actuary
Jack L. Getz	Assistant Vice President
Debra M. Jakubczak	Assistant Vice President
Michael D. Scott	Assistant Vice President
Gordon W. Niehoff	Assistant Secretary/Treasurer

Conflict of Interest

Conflict of Interest Disclosure Statements are executed annually by all directors and officers of the Company. A review of the statements for the years under examination indicated no material conflicts that had not previously been disclosed to the Board of Directors.

Corporate Records

A review was made of the Articles of Incorporation and Bylaws of the Company. Neither the Articles of Incorporation nor the Bylaws were amended during the period being examined.

The minutes of the meetings of the stockholders and board of directors were also reviewed for the period under examination. The meeting minutes properly documented the review of the previous examination report made as of December 31, 2001.

Acquisitions, Mergers, and Major Corporate Events

There have been no acquisitions, mergers or major corporate events during the examination period.

Surplus Debentures

The Company issued to Thomas Green, President of National States, a surplus note for \$2,000,000 with an interest rate of 4% per annum, dated August 20, 2004, approved by the Missouri Department of Insurance on August 19, 2004 and funded on September 1, 2004. Principal and unpaid interest on the surplus note was approximately \$2,026,667 at December 31, 2004.

AFFILIATED COMPANIES

Holding Company, Subsidiaries and Affiliates

The Company is a member of an insurance holding company system as defined in Section 382.010 RSMo, (Definitions). Annual Registration Statements were filed for 2002 through 2004 as required by Section 382.100 RSMo, (Registration).

Mr. Thomas R. Green, an individual and a practicing attorney, is the ultimate parent of the insurance holding company system. He directly owns 1,053,320 shares of voting common stock (a 30.09% interest) of National States Insurance Company. Mr. Green indirectly, through two real estate companies, owns 233,059 shares of the Company's common stock (a 6.66% interest). Relatives of Mr. Green and trusts established for the benefit of relatives of Mr. Green directly and indirectly own 1,714,364 shares (a 48.98% interest).

Note 10 to the 2004 Annual Statement stated that the Company is a registrant within the provisions of the holding company statutes of the state of Missouri. The note also stated that there are no subsidiaries or affiliates within the holding company system and there are no management agreements or service agreements with Thomas R. Green, the ultimate controlling person, or any other person within the Company.

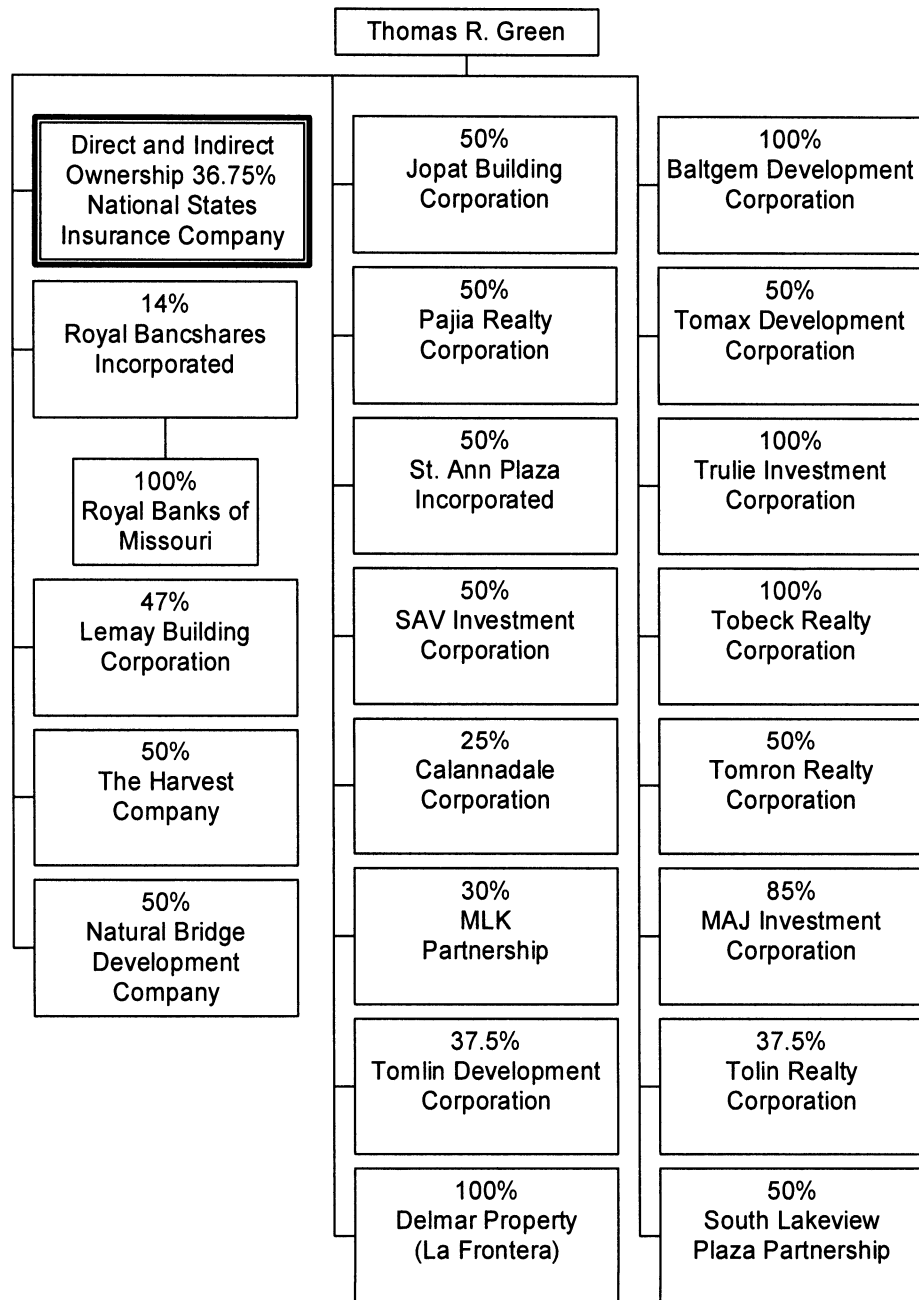
General Interrogatory 1.1 of the Annual Statement asks if the Company is a member of a holding company system consisting of two or more affiliated persons and the Company answered "no." In interrogatory 8.3 the Company responds that it is not affiliated with one or more banks, thrifts or securities firms. The Company, however, is an affiliate to Royal Bank which is owned 14% by Thomas R. Green.

The Company is a member of a holding company system and has many affiliates. The Company has subsequently begun showing the other members of the holding company system in its Quarterly Statements.

The Company should ensure that it completes all questions regarding its holding company system properly in the Quarterly and Annual statements and should also properly report all relationships in the Holding Company Registration statements.

Organizational Chart

The organizational chart below depicts the insurance holding company system as of December 31, 2004.



Intercompany Transactions

Fidelity Assurance, Inc.

Mr. Melvin Gross is a Director of the Company and owns 157,430 shares of the Company's common stock (4.5% of the outstanding shares). Mr. Gross owns and operates Fidelity Assurance, Inc., an insurance agency, which produces business for the Company. The premiums produced by and the commissions paid to the agency during the period being examined were as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Premiums	\$ 34,429,522	\$ 37,487,164	\$ 40,779,937
Commissions and Fees	\$ 6,592,766	\$ 7,295,206	\$ 9,658,203

Dale Turvey and Associates

Mr. Dale D. Turvey was elected to the Board of Directors of the Company in 1998. Mr. Turvey owns 15,792 shares of the Company's common stock (.5% of the outstanding shares). Mr. Turvey is President of Dale Turvey and Associates and is involved in the administration of the American Association of Uniform Services. In 2001, the Company collected policy fees of \$118,687 for the Association and remitted the fees to Dale Turvey and Associates.

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Premiums	\$ -	\$ -	\$ -
Commissions and Fees	\$ 55,548	\$ 75,461	\$ 95,982

Law Offices of Thomas R. Green

Mr. Thomas R. Green is a Director and President of the Company. Mr. Green, and relatives and trusts established for the benefit of relatives of Mr. Green own 3,000,743 shares of the Company's common stock (85.7% of the outstanding shares). Each year, the Company's Board of Directors authorizes the retainer of the Law Offices of Thomas R. Green as legal counsel. The Company paid fees of \$94,800; \$96,000 and \$98,400 for 2002 to 2004, respectively, for such legal representation.

The Law Offices of Thomas R. Green rent office space from the Company pursuant to a lease agreement which has been in place since 1990.

National Real Estate Management Corporation

Mr. Matthias D. Renner, Mr. Green's son-in-law, operates National Real Estate Management Corporation. National Real Estate Management Corporation acts as the real estate manager for the Company's home office building, which is partially occupied by other tenants. The Company paid management fees and rental commissions to National Real Estate Management Corporation, which in turn paid rent to the Company for office space.

FIDELITY BOND AND OTHER INSURANCE

The Company is a named insured on a financial institution bond that provides \$1,000,000 aggregate coverage. There is \$100,000 per loss deductible on this policy. This coverage complies with the suggested minimum amount of fidelity insurance according to NAIC guidelines.

The Company is also a named insured on insurance policies with the following limits at December 31, 2004:

<u>Coverage</u>	<u>Limits</u>	
Commercial Property Insurance	\$4,637,900	Aggregate
Business Personal Property	\$324,000	Aggregate
Commercial General Liability	\$2,000,000	Aggregate
	\$1,000,000	Per Occurrence
Commercial Automobile Liability	\$1,000,000	Per Occurrence
Workers Compensation	Statutory Limits	

EMPLOYEE BENEFITS

The Company offers typical benefits to employees including paid vacation, paid sick leave, paid holidays and funeral leave. The Company makes available, on an optional basis, employees' group insurance extending to hospitalization, medical, dental, disability, and life coverages. The Company contributes seventy-five percent of the cost of covering the employee and contributes fifty percent of the cost of covering the employee's family.

The Company has an employee profit sharing plan under which five percent of the Company's annual profit before federal income taxes in excess of \$400,000, limited

to fifteen percent of gross payroll, is distributed to employees as a profit sharing bonus, subject to approval of the board of directors. The allocation to individual employees is based on salary and years of full time service. Employees become eligible to participate after one full year of employment as of December 31 of the distribution year. The board of directors did not approve any profit sharing distributions during the examination period.

STATUTORY DEPOSITS

Deposits with the State of Missouri

The funds on deposit with the Missouri Department of Insurance as of December 31, 2004, as reflected below, were deemed sufficient in par and market value to meet the deposit requirements for the state of Missouri in accordance with Section 376.290 RSMo (Trust Deposits).

<u>Security</u>	<u>Par Value</u>	<u>Market Value</u>	<u>Statement Value</u>
US Treasury Note	750,000	767,902	749,314
US Treasury Note	<u>1,000,000</u>	<u>1,014,610</u>	<u>999,801</u>
Total	<u>1,750,000</u>	<u>1,782,512</u>	<u>1,749,115</u>

Deposits with Other States

The Company also has funds on deposit with various other states. Those funds on deposit as of December 31, 2004, were as follows:

<u>State</u>	<u>Security</u>	<u>Par Value</u>	<u>Market Value</u>	<u>Statement Value</u>
Arkansas	FNMA.	\$300,000	\$271,810	\$281,171
Florida	US Treasury Note	500,000	507,305	500,095
Florida	US Treasury Note	700,000	678,314	707,053
Florida	US Treasury Note	150,000	150,184	150,000
Georgia	US Treasury Note	50,000	49,313	49,927
New Mexico	US Treasury Note	150,000	149,748	150,074
North Carolina	US Treasury Note	200,000	199,664	200,100
North Carolina	US Treasury Note	250,000	251,973	250,000
South Carolina	US Treasury Note	250,000	249,580	250,083
South Carolina	US Treasury Note	300,000	304,383	300,053
Virginia	FNMA	<u>300,000</u>	<u>300,300</u>	<u>299,688</u>
Total		<u>\$3,150,000</u>	<u>\$3,112,390</u>	<u>\$3,138,428</u>

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operations

The Company is licensed in Missouri under Chapter 376 RSMo, (Life, Health and Accident Insurance) to write life and accident and health insurance. The Company is also licensed to write life and accident and health insurance in the following thirty-six states:

Alabama	Arizona	Arkansas	Colorado
Florida	Georgia	Idaho	Illinois
Indiana	Iowa	Kansas	Kentucky
Louisiana	Maryland	Michigan	Minnesota
Mississippi	Montana	Nebraska	Nevada
New Mexico	North Carolina	North Dakota	Ohio
Oklahoma	Oregon	Pennsylvania	South Carolina
South Dakota	Tennessee	Texas	Utah
Virginia	Washington	West Virginia	Wisconsin

The Company operates on the general agency plan. Approximately 2,000 active independent general and soliciting agents represent the Company. Direct premiums written by product line for the years being examined were as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Medicare Supplement	\$ 26,825,201	\$ 29,236,917	\$ 28,878,133
Home Health Care	13,997,915	17,484,760	19,751,054
Long Term Care	19,150,756	17,501,843	16,459,479
CHAMPUS Supplement	2,951,149	3,595,127	4,301,051
Hospital, Medical, Surgical	2,575,105	2,737,844	2,545,996
Dread Disease	301,002	244,758	235,648
All Other	<u>2,171,154</u>	<u>1,992,650</u>	<u>2,405,142</u>
Total A&H	\$ 67,972,282	\$ 72,793,899	\$ 74,576,503
Life	<u>37,726,600</u>	<u>37,542,202</u>	<u>35,390,675</u>
Grand Total	<u>\$ 105,698,882</u>	<u>\$ 110,336,101</u>	<u>\$ 109,967,178</u>

Policy Forms & Underwriting; Advertising & Sales Material and Treatment of Policyholders

The Missouri Department of Insurance has a Market Conduct staff that performs a review of these issues and generates a separate market conduct report. The most recent Missouri Market Conduct Examination was completed on June 30, 1998, and primarily covered operations in 1997. No Market Conduct Examinations were performed during the current examination period.

A review was made of the Company's underwriting procedures for long term care products. The Company's underwriting complied with its written underwriting policy and guidelines.

REINSURANCE

General

Premiums reported during the period under examination were as follows:

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Direct - Life	\$ 36,683,237	\$ 38,091,187	\$ 37,348,518
Direct - A&H	74,969,468	73,307,995	68,087,926
Reinsurance Assumed	-	-	-
Reinsurance Ceded	<u>14,865,226</u>	<u>12,544,713</u>	<u>13,126,449</u>
Net Premiums	<u><u>\$ 96,787,479</u></u>	<u><u>\$ 98,854,469</u></u>	<u><u>\$ 92,309,995</u></u>

Assumed

The Company did not assume any reinsurance during the period under examination.

Ceded

Annuity and Life Re America (ALRE)

Effective January 1, 2001, National States recaptured the life business ceded under a previous agreement with London Life International Reinsurance Corporation, replacing it with a \$10 million, 36.1% automatic coinsurance agreement with Annuity and Life Re America of Hartford, Connecticut. The proceeds of this transaction were used to fund the recapture as well as new business. Effective December 31, 2002, an amendment to the agreement increased the coinsurance to 46.85% for all policies covered by the agreement.

The Company should review its accounting treatment for the ALRE treaty and other reinsurance treaties. The ALRE treaty provides for a 5% renewal allowance for maintenance expenses and premium taxes. It is questionable whether this ceding

allowance is sufficient to cover anticipated renewal expenses. The Company should demonstrate to the Missouri Department of Insurance that these allowances are sufficient pursuant to Missouri Regulation 20 CSR 200-2.300(4)(A)1, or book a liability as required by this regulation.

Munich American Reinsurance Company (Munich)

Effective July 1, 2003, National States entered into an Automatic Reinsurance Agreement on a coinsurance basis with Munich. Pursuant to the agreement Munich accepted 50% of the risk on specified policy forms with an upper limit of \$17,500 per risk.

The agreement was amended effective January 1, 2004, to add coverage for the Company's new WLI-5 form. WLI-5 represents a new product launched April 1, 2004, with tighter underwriting and higher premium for tobacco users. This form replaced the Company's top selling form. The product was designed with the input of Munich and Optimum Re Insurance Company. The amendment provides for coinsurance of 25% of the risk with a limit of \$8,750 per life.

Subsequently, an addendum to the agreement effective January 1, 2005, increased Munich's coinsurance on newly issued WLI-5 policies to 37.5% of the risk up to \$13,125 per life and reduced the Company's required retention from 50% to 25% of the risk.

Optimum Re Insurance Company (Optimum)

Effective January 1, 2004, National States entered into an Automatic Reinsurance Agreement with Optimum. Pursuant to the agreement, the Company retained 50% of the

risk with an upper limit of \$17,500 per risk, and Optimum automatically accepted 50% of the remaining risk with a limit of \$8,750 per life. Therefore Optimum accepted 25% of the total risk on the policy form WLI-5 covered under this agreement, the same as Munich.

Subsequently, as with Munich, an addendum was made to the agreement effective January 1, 2005, increasing Optimum's coinsurance on newly issued WLI-5 policies to 37.5% of the risk up to \$13,125 per life and reduced the Company's required retention from 50% to 25% of the risk.

Accident and Health Reinsurance

The Company retains virtually all risk related to its accident and health written premium. There are, however, a few policies that are reinsured under agreements with Reassure America and Employers Reinsurance Corporation. National States Insurance Company is no longer writing new business on the policy forms covered by those reinsurance agreements and therefore the policies in force continue to decline. Total premiums ceded in 2004 pursuant to these agreements were \$1,029.

ACCOUNTS AND RECORDS

General

The Company's financial statements are prepared based on statutory accounting principles. Accounting entries are recorded on an internally developed general ledger software system maintained on a local area network. Accident and health policy administration is also recorded through the use of a program developed internally by the Company. Life policy administration is recorded through the use of the Life Support Plus system purchased by the Company from an outside vendor.

Independent Auditor and Actuary

An independent accounting firm audits the Company annually. The Company's auditor for the year ended December 31, 2004, was Brown Smith Wallace, LLC, Advisors and Accountants. A review was made of the workpapers of the last CPA audit. These workpapers and reports were used in the course of this examination as deemed appropriate. Reserves and related actuarial items reported in the financial statements were reviewed and certified by Rex Durlington, FSA, MAAA who is an employee of the Company.

Consulting actuary Tim Harris, FSA, MAAA, with Milliman USA, was retained by the Missouri Department of Insurance to review the adequacy of reserves and other related liabilities.

Information Systems

In conjunction with this examination, Andrew Balas, Information Systems Financial Examiner with the Missouri Department of Insurance conducted a review of the

Company's information systems. The Company does not have a formal business resumption plan or contract in place. The "Comments Previous Examination" section of this report included a recommendation that the Company develop a disaster recovery/business continuity plan, and that the plan should be updated and tested periodically, including the restoration of financially significant systems from backup media.

Information Systems

The Company was extremely slow in providing the Paid Claims Runoff. The Company must develop the capability to provide information as basic as a Life Claims Runoff on a more timely basis.

Risk Based Capital Calculation

The company made the decision in early July of 2004 to amend its 2003 annual statement and change its risk-based capital (RBC) calculation in regards to certain Home Health Care policies sold in Florida against the advice of the Chief Financial Examiner of the Missouri Department of Insurance. This change was significant because it increased the results of the RBC calculation substantially and without the change the Company's RBC level was approaching the RBC action levels.

The Company used the same classification in the December 31, 2004, Annual Statement. The actuarial firm of Milliman USA reviewed the classification of these policies and determined that the classification used by the Company was inappropriate. The Company should amend its 2004 Annual Statement to properly reflect the classification of these policies and the resulting calculation of the RBC.

FINANCIAL STATEMENTS

The following financial statements, with supporting exhibits, present the financial condition of the Company as of December 31, 2004, and the results of operations for the fiscal period then ended. Any examination adjustments to the amounts reported in the financial statements and/or comments regarding such are made in the "Notes to the Financial Statements," which follow the financial statements.

There may have been additional differences found in the course of this examination, which are not shown in the "Notes to the Financial Statements." These differences were determined to be immaterial in relation to the financial statements, and therefore were only communicated to the Company and noted in the workpapers for each individual financial statement item.

ASSETS

	Notes	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds		\$92,427,688		\$92,427,688
Real estate occupied by the company		2,532,616		2,532,616
Cash and short term investments		559,962		559,962
Contract Loans		2,811,159		2,811,159
Investment income due and accrued		1,401,976		1,401,976
Premiums due and unpaid	1	1,289,805		1,289,805
Premiums deferred and not yet due	2	13,798,123	\$603,367	13,194,756
Federal and foreign income taxes	4	138,162		138,162
Net deferred tax asset		8,288,935	6,594,433	1,694,502
Guaranty funds receivable		207,103		207,103
EDP equipment		42,391		42,391
Furniture and Equipment		11,133	11,133	-
Other assets non-admitted		<u>677</u>	<u>677</u>	<u>-</u>
Total Assets		\$123,509,730	\$7,209,610	\$116,300,120

LIABILITIES SURPLUS AND OTHER FUNDS

	<u>Notes</u>	
Aggregate reserve for life contracts		\$50,295,413
Aggregate reserve for accident and health contracts	1	26,069,660
Life contract claims		1,049,276
Accident and health contract claims		16,416,830
Premiums received in advance	1	1,318,189
Other amounts payable on reinsurance ceded	4	5,053,502
Interest Maintenance Reserve		224,656
Commissions to agents due or accrued	3	764,528
General expenses due or accrued		174,675
Taxes, licenses and fees due or accrued		390,523
Amounts withheld or retained by company as trustee		343,350
Remittances and items not allocated		139,625
Borrowed money		1,300,758
Asset valuation reserve		<u>323,916</u>
Total Liabilities		\$103,864,901
Common capital stock		\$7,000,000
Surplus notes		2,000,000
Paid in and contributed surplus		667,619
Unassigned funds (surplus)		4,325,910
Examination adjustments		<u>(1,558,310)</u>
Total Capital and Surplus		\$12,435,219
Total Liabilities and Capital and Surplus		<u>\$116,300,120</u>

SUMMARY OF OPERATIONS

Premium considerations	\$92,309,995	
Net investment income	4,847,092	
Amortization of Interest Maintenance Reserve	37,888	
Commission allowance on reinsurance ceded	4,075,314	
Miscellaneous income	<u>25,860</u>	
Total Revenue		\$101,296,149
Death benefits	\$11,966,467	
Disability benefits and benefits under A&H policies	49,826,965	
Surrender benefits and withdrawals for life contracts	954,642	
Increase in aggregate reserves	<u>9,453,861</u>	
Subtotal benefit costs	\$72,201,935	
Commissions on premiums	21,810,671	
General insurance expenses	7,591,125	
Insurance taxes, licenses and fees	2,693,066	
Increase in loading on deferred and uncollected premiums	<u>(638,117)</u>	
Subtotal insurance expenses	<u>\$31,456,745</u>	
Total benefit costs and insurance expenses		<u>103,658,680</u>
Gain from operations before federal income taxes and realized capital gains or (losses)		(\$2,362,531)
Federal income taxes incurred	(\$427,630)	
Net realized capital gains or (losses)	<u>(2,180)</u>	
Net Income		<u>(\$2,792,341)</u>

CAPITAL AND SURPLUS ACCOUNT

Capital and Surplus Beginning of Year		\$15,042,549
Net Income	(\$2,792,341)	
Change in Deferred Income Tax	499,865	
Change in Nonadmitted Assets	(720,386)	
Change in AVR	(36,158)	
Change in Surplus Notes	2,000,000	
Examination Changes	<u>(1,558,310)</u>	<u>(2,607,330)</u>
Capital and Surplus, end of year		<u>\$12,435,219</u>

NOTES TO FINANCIAL STATEMENTS

Note 1	Premium Due and Unpaid	\$1,289,805
	Aggregate Accident and Health Reserve	26,069,660
	Premium Received in Advance	1,318,189

The examiner recalculated these accounts correcting for an error found in the paid-to-date in the Company's database resulting in these examination adjustments which net to a decrease in surplus of \$956,658. Premium Due and Unpaid was reduced from \$2,873,026 by \$1,583,221. Aggregate Accident and Health Reserve was reduced from \$27,512,954 by \$1,443,294. Advance Premium was increased from \$501,458 by \$816,731.

Note 2	Deferred Premiums	\$13,194,756
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Deferred premium was reduced from the Company amount of \$13,876,584 by \$681,828. The Company's reinsurance treaty with Munich American Reinsurance Company was made on a collected premium basis. The terms of this agreement result in a proportionate share of the deferred premium being ceded to the reinsurer. The adjustment reflects the amount the Company should have reported as ceded deferred premium.

Note 3	Commissions Payable	\$764,528
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Commissions Payable was reduced from the Company amount of \$1,002,011 by \$237,483. Because the Premium Due and Unpaid was reduced, the associated commission payable was also reduced. The reduction to Commission Payable was determined by applying a 15% commission rate to the reduction in the Premium Due and Unpaid.

Note 4	Federal and foreign income taxes	\$138,162
	Other amounts payable on reinsurance ceded	5,053,502

Federal and foreign income taxes receivable was increased from the Company amount of \$57,125 by \$81,037 to reflect a tax benefit related to an adjustment to reflect an unrecorded payable to reinsurers. Other amounts payable on reinsurance ceded was increased from \$4,815,158 by \$238,344 to reflect investment income recorded by the Company that should have been ceded to its reinsurer.

EXAMINATION CHANGES

Total Capital & Surplus Per Company

Common capital stock	\$7,000,000
Surplus notes	2,000,000
Gross paid in surplus	667,619
Unassigned funds	4,325,910
Total capital and surplus per company	\$13,993,529

Assets:

Premium Due and Unpaid	1		\$1,583,221
Deferred Premiums	2		681,828
Federal and foreign income tax	4	\$81,037	

Liabilities:

Premium Received in Advance	1		816,731
Aggregate Accident and Health Reserve	1	1,443,294	
Commissions Payable	3	237,483	
Other amounts payable on reinsurance ceded	4		\$238,344
		\$1,761,814	\$3,320,124

Net change in unassigned surplus	(1,558,310)
----------------------------------	-------------

Total Capital & Surplus Per Examination

Common capital stock	\$7,000,000
Surplus notes	2,000,000
Gross paid in surplus	667,619
Unassigned funds	2,767,600
Total capital and surplus per examination	\$12,435,219

GENERAL COMMENTS AND/OR RECOMMENDATIONS

Comments Previous Examination

Page 4

The Company should regularly test its business continuity/disaster recovery plan and modify it as necessary based on the test results. Without a current plan, improved via periodic walk-through/restoration testing, the contingency planning process has diminished value because a variety of unforeseen problems may arise that have not been “refined out” of the recovery process.

Holding Company System

Page 8

The Company should ensure that it completes all questions regarding its holding company system properly in the Quarterly and Annual statements and should also properly report all relationships in the Holding Company Registration statements.

Reinsurance

Page 16

The Company should review its accounting treatment for the ALRE treaty and other reinsurance treaties. The ALRE treaty provides for a 5% renewal allowance for maintenance expenses and premium taxes. It is questionable whether this ceding allowance is sufficient to cover anticipated renewal expenses. The Company should demonstrate to the Missouri Department of Insurance that these allowances are sufficient pursuant to Missouri Regulation 20 CSR 200-2.300(4)(A)1, or book a liability as required by this regulation.

Information Systems

Page 20

The Company was extremely slow in providing the Paid Claims Runoff. The examiner requested the runoff on June 13, 2005, and the Company provided the file on September 6, 2005. The Company must develop the capability of providing information as basic as a Life Claims Runoff on a more timely basis.

Risk Based Capital Calculation

Page 20

The Company should amend its 2004 Annual Statement to properly reflect the classification of certain Home Health Care policies sold in Florida that it reclassified originally on the 2003 Annual Statement. The reclassification of these policies resulted in an overstatement of the Company's Risk Based Capital (RBC) level.

SUBSEQUENT EVENTS

The Company entered into a substantial new reinsurance agreement with Northstar Reinsurance Ireland Limited effective September 30, 2005. This examination was rolled forward to that date and examination procedures were performed as necessary to reflect the current effect of the changes found at December 31, 2004 on the September 30, 2005, quarterly filing. In addition, the accounting for the reinsurance agreement was reviewed and changes to the quarterly filing based upon the review of that transaction are also reflected in this roll forward to September 30, 2005.

FINANCIAL STATEMENTS - SEPTEMBER 30, 2005

The following financial statements, with supporting exhibits, present the financial condition of the Company as of September 30, 2005, and the results of operations for the fiscal period January 1, 2005 through September 30, 2005. Any examination adjustments to the amounts reported in the financial statements and/or comments regarding such are made in the "Notes to the Financial Statements," which follow the financial statements.

There may have been additional differences found in the course of this examination, which are not shown in the "Notes to the Financial Statements." These differences were determined to be immaterial in relation to the financial statements, and therefore were only communicated to the Company and noted in the workpapers for each individual financial statement item.

ASSETS - SEPTEMBER 30, 2005

	<u>Notes</u>	<u>Assets</u>	<u>Nonadmitted Assets</u>	<u>Net Admitted Assets</u>
Bonds		\$69,710,928		\$69,710,928
Real estate occupied by the company		2,450,131		2,450,131
Cash and short term investments		(3,246,834)		(3,246,834)
Contract Loans		3,593,880		3,593,880
Investment income due and accrued		875,902		875,902
Premiums due and unpaid	1	1,026,461		1,026,461
Premiums deferred and not yet due	2	9,005,898	\$773,551	8,232,347
Receivable Under Reinsurance Contracts		454,428		454,428
Federal and foreign income taxes		267,435		267,435
Net deferred tax asset		8,288,935	7,016,856	1,272,079
Guaranty funds receivable		201,900		201,900
EDP equipment		30,785		30,785
Furniture and Equipment		8,130	8,130	-
Total Assets		<u>\$ 92,667,979</u>	<u>\$ 7,798,537</u>	<u>\$ 84,869,442</u>

LIABILITIES SURPLUS AND OTHER FUNDS - SEPTEMBER 30, 2005

	<u>Notes</u>	
Aggregate reserve for life contracts		\$24,855,481
Aggregate reserve for accident and health contracts	1	27,066,221
Life contract claims		282,363
Accident and health contract claims		13,440,522
Premiums received in advance	1	1,165,944
Other amounts payable on reinsurance ceded		4,861,904
Interest Maintenance Reserve		246,665
Commissions to agents due or accrued	3	463,706
General expenses due or accrued		186,862
Taxes, licenses and fees due or accrued		201,863
Amounts withheld or retained by company as trustee		699,093
Remittances and items not allocated		123,521
Borrowed money		-
Asset valuation reserve		<u>323,916</u>
Total Liabilities		\$73,918,061
Common capital stock		\$7,000,000
Surplus notes		2,086,667
Paid in and contributed surplus		667,619
Unassigned funds (surplus		7,461,929
Examination adjustments		<u>(6,264,834)</u>
Total Capital and Surplus		<u>\$10,951,381</u>
Total Liabilities, Capital and Surplus		<u>\$84,869,442</u>

SUMMARY OF OPERATIONS - SEPTEMBER 30, 2005

Premiums considerations	\$65,563,120	
Net investment income	3,800,317	
Amortization of interest maintenance reserve (IMR)	36,641	
Commissions allowances on reinsurance ceded	3,340,430	
Miscellaneous income	<u>(174,686)</u>	
Total Revenue		\$72,565,822
Death benefits	8,977,777	
contracts	36,129,026	
Surrender benefits and withdrawals for life contracts	857,010	
Increase in aggregate reserves	<u>6,675,170</u>	
Subtotal benefit costs		\$52,638,983
Commissions on premiums	14,858,776	
General insurance expenses	5,704,142	
Insurance taxes, licenses and fees	1,755,244	
Increase in loading on deferred and uncollected premiums	<u>63,760</u>	
Subtotal insurance expenses		<u>\$22,381,922</u>
Total benefit costs and insurance expenses		<u>75,020,905</u>
Gain from operations before dividends and federal income taxes and realized capital gains or (losses)		(\$2,455,083)
Federal income tax benefit	\$205	
Net realized capital gain (loss)	<u>30,213</u>	
Net income		<u><u>(\$2,424,665)</u></u>

CAPITAL AND SURPLUS ACCOUNT

Capital and surplus; December 31; prior year		\$13,993,529
Net income	(\$2,424,665)	
Change in Nonadmitted Assets	(588,927)	
Change in Surplus Notes	86,666	
Transferred to Surplus (capital changes)	(86,666)	
Change in surplus as a result of reinsurance (surplus adjustments)	6,236,278	
Examination Changes	<u>(6,264,834)</u>	<u>(3,042,148)</u>
Capital and surplus as of statement date		<u><u>\$10,951,381</u></u>

NOTES TO FINANCIAL STATEMENTS - SEPTEMBER 30, 2005

Note 1	Premium Due and Unpaid	\$1,026,461
	Aggregate Accident and Health Reserve	27,066,221
	Premium Received in Advance	1,165,944

The errors noted at December 31, 2004, remained uncorrected at September 30, 2005. These accounts are adjusted here to correct for that database error. Premium Due and Unpaid was reduced from \$2,015,205 by \$988,744. Aggregate Accident and Health Reserve was reduced from \$28,035,969 by \$969,748. Advance Premium was increased from \$670,796 by \$495,148.

Note 2	Deferred Premiums	\$8,232,347
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Deferred premium was reduced from the Company amount of \$14,131,349 by \$5,899,002. The Company's reinsurance treaty with Munich American Reinsurance Company was made on a collected premium basis. The terms of this agreement result in a proportionate share of the deferred premium being ceded to the reinsurer. \$698,694 of the adjustment reflects the amount the Company should have reported as ceded deferred premium.

The Company's new reinsurance agreement with Northstar Reinsurance Ireland Limited (Northstar) effective September 30, 2005 was reviewed. The agreement includes wording which indicates that like the Munich American Reinsurance Company treaty, it is on a collected premium basis. Northstar has taken the position that it is a collected basis treaty, however, the Company has reported it as though it were on an annual premium basis and reported \$5,200,308 in deferred premium asset. This adjustment recognizes that under a collected premium basis treaty the deferred premium is ceded to the reinsurer, thus the asset has been reduced by \$5,200,308.

The Company's accounting for this agreement is in violation of Missouri Regulation 20 CSR 200-2.300(4)(A) 3, which states:

"No life insurer subject to this rule for reinsurance ceded shall reduce any liability or establish any asset in any financial statement filed with the division if, by the terms of the reinsurance agreement, in substance or effect, the ceding insurer can be deprived of surplus at the reinsurer's option or automatically upon the occurrence of some event..."

Based on the Company's interpretation of the treaty language and the fact that it has accounted for the treaty as if the dispute with the reinsurer will be resolved fully in its favor, the occurrence of a resolution other than in full favor of the Company will result in a reduction of the Company's surplus as stated on its third quarter statement.

Note 3	Commissions Payable	\$463,706
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Commissions Payable was reduced from the Company amount of \$612,018 by \$148,312. Because the Premium Due and Unpaid was reduced, the associated commission payable was also reduced. The reduction to Commission Payable was determined by applying a 15% commission rate to the reduction in the Premium Due and Unpaid.

EXAMINATION CHANGES - SEPTEMBER 30, 2005

Total Capital & Surplus Per Company

Common capital stock	\$7,000,000
Surplus notes	2,086,666
Gross paid in surplus	667,619
Unassigned funds	7,461,929
Total capital and surplus per company	\$17,216,214

Notes	Increase In Surplus	Decrease In Surplus
1		\$988,744
2		5,899,002
1	\$969,748	
1		495,148
3	148,312	
	\$1,118,060	\$7,382,894

Assets:

Premium Due and Unpaid
Deferred Premium

Liabilities:

Aggregate Accident and Health Reserve
Premium Received in Advance
Commissions Payable

Net change in unassigned surplus

Total Capital & Surplus Per Examination

Common capital stock	\$7,000,000
Surplus notes	2,086,667
Gross paid in surplus	667,619
Unassigned funds	1,197,095
Total capital and surplus per examination	\$10,951,381

EVENTS SUBSEQUENT TO SEPTEMBER 30, 2005

The Company entered into a letter of intent agreement with Northstar Reinsurance Ireland Limited as of December 30, 2005, to modify the original reinsurance agreement between the parties that was effective September 30, 2005. On January 27, 2006, the Company signed Amendment One to the original reinsurance agreement. The amendment clarified that the reinsurer would be paid on an annual basis rather than a collected basis. Due to the changes to the contract wording and resolution of the dispute between the parties the Company will see an increase in surplus due to the reinsurance contract of \$5,878,006 at December 31, 2005.

ACKNOWLEDGMENT

The assistance and cooperation extended by National States Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Richard Hayes, CFE, and Michael Gruner, CPA, CFE, examiners for the Missouri Department of Insurance, participated in this examination. Tim Harris, FSA, MAAA, with Milliman USA, reviewed the actuarial assumptions and methods used by the Company in determining policy reserves and related actuarial items.

VERIFICATION

State of Missouri)
) ss
County of Cole)

I, Wyatt Sample, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of the Company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.

Wyatt R Sample
Wyatt R Sample, CFE, CPA
Examiner-in-Charge
Missouri Department of Insurance

Sworn to and subscribed before me this 9th day of December.
My commission expires:

2008
JACQUELINE A. GREEN
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County

My Commission Expires March 22, 2008

Jacqueline A. Green
Notary Public

SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with the National Association of Insurance Commissioners procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.

Christiana Dugopolski
Christiana Dugopolski, CFE, CPA
Audit Manager
Missouri Department of Insurance



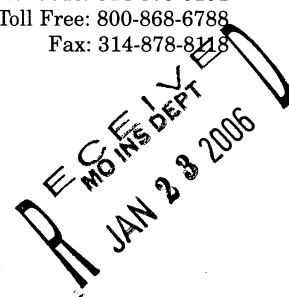
National States Insurance COMPANY

1830 Craig Park Ct., St. Louis, Missouri 63146, Area Code: 314-878-0101

Toll Free: 800-868-6788

Fax: 314-878-8118

January 16, 2006



Mr. Kirk Schmidt
Chief Financial Examiner
Missouri Department of Insurance
P.O. Box 690
Jefferson City, MO 65102-0690

Re: Examination Report for period ending December 31, 2004

Dear Mr. Schmidt:

As per your letter dated December 22, 2005, I am submitting our responses to the Examination Report in writing. We would like to review the second draft of the report before it is finalized. We would also like for our responses to be included in the report as a public document.

Page 4 – Disaster Recovery Plan

A copy of our disaster plan was never requested during the exam. A copy is attached.

Page 5 – Management

Martin E. Harrington is Chairman of the Board, not President.

Page 10 – Intercompany Transactions – Fidelity Insurance

The premiums for 2004 are incorrect at \$49,050,521. The amount should be \$34,429,522. It would not follow that commissions would go down, but premium would be up.

Page 12 – Fidelity Bond and Employee Benefits

The fidelity bond coverage for commercial property insurance was increased from \$4,637,900 to \$5,000,000 and the business personal property was increased from \$324,000 to \$400,000.

“The Company has an employee profit sharing plan, **subject to approval of the board of directors**, under which five percent of the Company’s annual profit

The board has not approved any bonus.

Page 14 – Deposits with Other States

Florida US Treasury Note for \$150,000, the statement value and market value should be swapped.

Page 16 – Ceded Reinsurance – ALRE

On what basis is the statement that the ceding percentage of 5% is insufficient to cover anticipated renewal expenses, since this was not covered by the examining staff during the audit?

Page 20 – Information Systems

This audit lasted nearly 9 months, and during that time, there were constant requests for information, all of which were provided. To single out one request does not seem material and this should be deleted from the examination report. Further, this point has already been included in a December 22, 2005 letter from Wyatt Sample that summarizes the items not documented in the final examination that require management's attention.

Page 20 - RBC

This matter is pending in the Circuit Court of St. Louis County. The Company feels their position is correct. We have received no information from Milliman, nor has Milliman appeared or testified at any hearings or court proceedings, so we don't understand why this is referred to.

Page 33 – Subsequent Events – Notes to Financial Statements

The Northstar Reinsurance Treaty was amended December 30, 2005 and a copy of the Letter of Intent was provided to you 1/3/06. A copy of our revised 9/30/05 balance sheet is attached.

If you have any questions please feel free to give me a call at 314-878-0101 ext. 205 or e-mail me at pcurran@nstates.com.

Sincerely,



Patricia I. Curran
CFO

Attachments

National States Insurance Company
Liabilities, Surplus and other Funds - September 30, 2005

		Adjustment by <u>NSI</u>	Restated <u>Liab/Cap/Surplus</u>
Aggregate reserve for life contracts	\$24,855,481	(\$14,076,994)	\$10,778,487
Aggregate reserve for accident and health contracts	27,066,221		27,066,221
Life contract claims	282,363		282,363
Accident and health contract claims	13,440,522		13,440,522
Premiums received in advance	1,165,944		1,165,944
Other amounts payable on reinsurance ceded	4,861,904	12,944,868	17,806,772
Interest Maintenance Reserve	246,665		246,665
Commissions to agents due or accrued	463,706		463,706
General expenses due or accrued	186,862		186,862
Taxes, licenses and fees due or accrued	201,863		201,863
Amounts withheld or retained by company as trustee	699,093		699,093
Remittances and items not allocated	123,521		123,521
Borrowed money	0		0
Asset Valuation reserve	<u>323,916</u>		<u>323,916</u>
Total Liabilities	\$73,918,061	(\$1,132,126)	\$72,785,935
 Common capital stock	 \$7,000,000		 \$7,000,000
Surplus notes	2,086,667		2,086,667
Paid in and contributed surplus	667,619		667,619
Unassigned funds (surplus)	7,461,929	677,698	8,139,627
Examination adjustments	<u>(6,264,834)</u>	<u>5,200,308</u>	<u>(1,064,526)</u>
 Total Capital and Surplus	 \$10,951,381	 \$5,878,006	 \$16,829,387
 Total Liabilities, Capital and Surplus	 <u>\$84,869,442</u>	 <u>\$4,745,880</u>	 <u>\$89,615,322</u>

National States Insurance Company
Assets - September 30, 2005

	<u>Assets</u>	<u>Nonadmitted Assets</u>	<u>Net Admitted Assets</u>	<u>Adjusted by NSI</u>	<u>Restated Net Admitted Assets</u>
Bonds	\$69,710,928		\$69,710,928		69,710,928
Real estate occupied by the company	2,450,131		2,450,131		2,450,131
Cash and short term investments	(3,246,834)		(3,246,834)		(3,246,834)
Contract Loans	3,593,880		3,593,880		3,593,880
Investment income due and accrued	875,902		875,902		875,902
Premiums due and unpaid	1,026,461		1,026,461		1,026,461
Premiums deferred and not yet due	9,005,898	773,551	8,232,347	5,200,308	13,432,655
Receivable Under Reinsurance Contracts	454,428		454,428	(454,428)	0
Federal and foreign income taxes	267,435		267,435		267,435
Net deferred tax asset	8,288,935	7,016,856	1,272,079		1,272,079
Guaranty funds receivable	201,900		201,900		201,900
EDP Equipment	30,785		30,785		30,785
Furniture and Equipment	8,130	8,130	0		0
Total Assets	<u>\$92,667,979</u>	<u>\$7,798,537</u>	<u>\$84,869,442</u>	<u>\$4,745,880</u>	<u>\$89,615,322</u>